



U.S. Department of Justice

United States Trustee Central District of California

*411 W. Fourth St
Suite 9041
Santa Ana, CA 92701
(714) 338-3400
FAX (714) 338-3421*

*725 South Figueroa St.
Suite 2600
Los Angeles, CA 90017
(213) 894-6811
FAX (213) 894-2603*

*3685 Main St.
Suite 300
Riverside, CA 92501
(909) 276-6990
FAX (909) 276-6973*

*21051 Warner Center Lane
Suite 115
Woodland Hills, CA 91367
(818) 716-8800
FAX (818) 716-1576*

To: Prospective Creditors' Committee Members

For those of you who are not attorneys, or for whom this is a first experience, chapter 11 may appear to be an extraordinarily complex and mysterious process. Answers to such seemingly simple questions such as: "When am I going to get my money?" or "How much of my money will I get back?" or "What is a creditors' committee?" are seldom simple or clear. For this reason, the Office of the United States Trustee has prepared the accompanying summary to address these questions as well as to give you an idea of what to expect during the course of a chapter 11 case.

As you will learn, the creditors' committee plays a very important role in a chapter 11 case, committee membership carries with it various rights and responsibilities, and serving on a committee will certainly require a time commitment. It is our hope, however that knowing the facts will encourage you to volunteer to serve.

If you have any questions please feel free to contact the analyst or attorney assigned to your case.



U.S. Department of Justice

**United States Trustee
Central District of California**

411 W. Fourth St
Suite 9041
Santa Ana, CA 92701
(714) 338-3400
FAX (714) 338-3421

725 South Figueroa St.
Suite 2600
Los Angeles, CA 90017
(213) 894-6811
FAX (213) 894-2603

3685 Main St.
Suite 300
Riverside, CA 92501
(909) 276-6990
FAX (909) 276-6973

21051 Warner Center Lane
Suite 115
Woodland Hills, CA 91367
(818) 716-8800
FAX (818) 716-1576

CREDITORS' GUIDE TO CHAPTER 11

I. WHAT IS CHAPTER 11?

A. Overview

The purpose behind chapter 11 is to maximize the amount of money ultimately repaid to the creditors and to allow the debtor to emerge from bankruptcy as a revitalized entity which generates employment and pays taxes. Chapter 11 is a part of the federal Bankruptcy Code that permits the bankrupt entity - - known as the debtor - - to continue its business while negotiating a new arrangement with its creditors. This new arrangement is called a "plan of reorganization." Such a plan might call for creditors to wait a certain length of time for their money; to accept fewer than 100 cents on the dollar; or might even entail certain creditors providing additional funding so that the debtor can continue its business and make a larger repayment in the future.

Chapter 11 is commenced by the filing of a "bankruptcy petition" in the United States Bankruptcy Court and continues until either the court confirms a plan of reorganization, the case is converted to chapter 7 and the estate is liquidated, a chapter 11 trustee is appointed or the case is dismissed. For example, if the debtor's finances render any plan unworkable, or if other facts warrant, the Bankruptcy Court may convert the case to one under chapter 7. In such circumstances, the court will order the Office of the United States Trustee to appoint a trustee to supervise the orderly sale of all of the debtor's assets, and creditors will receive payment according to the priorities specified in the Bankruptcy Code. Alternatively, the bankruptcy case may be dismissed, leaving creditors whatever rights and remedies they would have had if the bankruptcy had never been filed.

B. How Much Of My Money Will I Get Back?

The amount of money you will receive will depend, in part, upon: (1) how much money is in the bankruptcy estate; (2) the amount of your claim; (3) the type of claim you have; (4) the costs incurred during the bankruptcy case itself; and (5) the terms of the plan of reorganization.

1. WHAT IS THE BANKRUPTCY ESTATE?

The filing of the bankruptcy petition creates a bankruptcy estate. With a few exceptions, the estate consists of all assets of the debtor as of the time the petition was filed and all assets the debtor acquires during the pendency of the proceeding. (The legal definition is set forth at 11 U.S.C. § 541.)

"Assets" of the estate include cash, receivables, real property, potential recoveries from lawsuits by the debtor against third parties, assets held by third parties for the benefit of the debtor, contract rights the debtor chooses to retain (unfavorable contracts can be rejected), and rights to rent real estate or equipment under favorable leases (burdensome leases can be rejected).

2. WHAT IS A CLAIM?

In chapter 11, creditors hold claims against the debtor. For example, if prior to the filing of the debtor's bankruptcy petition you sold the debtor photocopy equipment for \$1,000 and you delivered the equipment but the debtor had not paid for it at the time the petition was filed, you hold a claim for \$1,000 unless somebody convinces the Bankruptcy Court that your claim should be reduced or eliminated.

3. WHAT ARE THE DIFFERENT TYPES OF CLAIMS?

a. Unsecured Claims

In bankruptcy, claims are either "unsecured" or "secured." An unsecured claim is a simple claim for payment. For example, if you sold the debtor photocopier equipment for \$1,000 in exchange for the debtor's promise to pay, you hold an unsecured claim. You have the right to demand repayment - - but you do not have any rights with regard to the equipment. In bankruptcy, the fact that your claim arose out of the sale of particular equipment affords you no special treatment. You will be paid from what is left in the estate after the secured claims are paid.

b. Secured Claims

A secured claim is both a claim for payment and a claim of ownership in particular property to guarantee payment. Thus, if in addition to the debtor's promise to pay, the debtor granted you a lien on the equipment, you might hold a secured claim equal to the current value of the equipment which entitles you to demand its return. If the equipment is now worth less than \$1,000, you would also hold an unsecured claim for the amount of the shortfall.

Bankruptcy usually recognizes the interests that secured claims have in particular pieces of property. Bankruptcy will not permit such property to be used to pay unsecured claims, except to the extent that the property is worth more than the secured claim.

The greater the value of the secured claims, the less will be available to pay unsecured claims. Therefore, unsecured creditors and their committees will often seek to convince the Bankruptcy Court to not recognize particular secured claims. The most common grounds are listed at 11 U.S.C. §§ 547 & 548.

c. What determines which unsecured claims get paid first?

Certain types of unsecured claims may be paid in full before other unsecured claims are paid at all. Expenses incurred after the bankruptcy petition was filed, for example, are “administrative” unsecured claims that have payment priority over pre-petition’s unsecured claims. Thus, a warehouse’s claim for \$500 rent to store and protect the debtor’s inventory after the filing would be an “administrative” claim that would be paid before your \$1,000 unsecured claim for the equipment you delivered before the bankruptcy. If the estate has only \$550 with which to pay claims, the warehouse would receive \$500 on its \$500 claim, you would receive no more than \$50 on your \$1,000 claim. If there are \$50 worth of other administrative claims standing in line between the warehouse owner’s claim and your own, you could receive nothing at all.

Section 507 of the Bankruptcy Code contains a list of the types of unsecured claims and the order in which each gets paid. Types of claims include without limitations, (a) administrative claims; (b) claims for wages earned within 90 days before the filing of the bankruptcy petition; and (c) claims of governmental units for unpaid property taxes assessed within one year before the filing of the bankruptcy petition. If there is no money left over after the estate has fully paid the other types of claims just mentioned, your unsecured claim for \$1,000 would not be paid at all.

Finally, it is very likely that there will be other unsecured claims entitled to be paid at the same time as yours. If the estate does not have enough money to pay all such claims in full, they will share, pro rata, in the funds available. Thus, if the estate has only \$500 left to pay your unsecured claim of \$1,000 and a second unsecured claim of \$10,000 to the debtor’s widget supplier, you would receive \$45.45 on your \$1,000 claim, and the widget supplier would receive \$454.55 on its \$10,000 claim.

4. WHAT COSTS ARE INCURRED DURING A CHAPTER 11 BANKRUPTCY CASE?

The amount of funds in the estate available to pay claims will be reduced by the costs that the debtor has incurred during the course of the bankruptcy case. The costs can be broken down into two general categories: the cost of running the business and the cost of obtaining the confirmation of a plan of reorganization.

a. What are the costs of running the business?

In a chapter 11 case the debtor continues to operate its business, and therefore, will continue to expend the assets of the estate. The hope is that by continuing in business the debtor will, in the long run, be able to pay more claims than if the debtor were to cease operations and liquidate.

Operating a chapter 11 business typically involves updating lapsed insurance policies, negotiating new agreements with suppliers, determining which pre-bankruptcy contracts and leases to continue, and spending money on inventory, equipment, and wages. In addition, the debtor, especially in a large case, will likely hire lawyers, accountants, appraisers and other professionals to assist in running the business. The debtor may also hire counsel to sue third

parties to recover assets of the estate. The allowed claims that result from these post-filing expenses will generally be paid in full as “administrative” claims before unsecured claims are paid at all.

b. What are the costs of obtaining a plan of reorganization?

The Bankruptcy Code sets forth a list of steps which the debtor must complete before a plan can be confirmed. Within 15 days of the entry of an order for relief by the Bankruptcy Court, the debtor must file with the Bankruptcy Code a comprehensive list of its assets and liabilities, its current income and expenditures, and a list of outstanding contracts and leases. If the debtor requires more time, its lawyer must ask the Bankruptcy Court for the additional time.

During the first 120 days of the bankruptcy case the debtor has the exclusive right to file a proposed plan of reorganization. The debtor should use this time to formulate a plan of reorganization and negotiate its terms with the creditors' committee and secured creditors. Even with extensive negotiations, however, it is sometimes difficult for the debtor to put together a plan within the 120 days and, therefore, debtors frequently ask request the Bankruptcy Court to grant an extension of the exclusivity period. If the debtor does not file a plan before its exclusivity period expires, any creditor or the creditors' committee may file a plan.

Confirmation of a plan requires that creditors vote to approve the plan by margins set forth in the Bankruptcy Code. If the debtor files a proposed plan within its exclusivity period, an additional 60 days are added to the exclusivity period for the debtor to solicit acceptances of the proposed plan.

To solicit acceptances, the debtor sends creditors a ballot along with a copy of the plan and a "disclosure" statement. The disclosure statement is to give creditors enough information to allow them to make an informed decision as to whether or not to vote for the plan. Before any party proposing a plan can begin soliciting acceptances, the party must convince the bankruptcy judge that the disclosure statement is adequately informative.

Plan formulation and negotiation usually involve appraisers, consultants, financial advisors, and lawyers. Again, all the costs and professional fees incurred in preparing the required documents and complying with the procedures are normally paid in full before unsecured claims are paid.

5. WHAT ARE THE POSSIBLE TERMS OF THE PLAN OF REORGANIZATION?

A plan of reorganization can provide for virtually any type of distribution agreed to by the creditors. For example, the warehouse owner with a \$500 administrative rent claim might consent to taking only 80 cents on the dollar in the hope that the post petition reorganized debtor will continue to rent space. This would leave more money in the estate for the next creditor in line-- possibly you. Similarly, a secured creditor might agree to restructure the terms of its debt or even put in new money if the plan promises an ultimate pay out larger than the creditor would receive if the estate were liquidated.

C. When Will I See My Money?

A plan of reorganization can provide for different lengths of repayment periods for the different types of claims. For example, the claim of the warehouse owner might be repaid over ten months and your \$1,000 claim for the photocopy equipment might be paid upon confirmation of the plan. It is extremely unlikely that you will see your money before the confirmation of a plan, or until after a bankruptcy trustee sells all of the debtor's property.

II. THE CREDITORS' COMMITTEE

The Bankruptcy Code empowers the U.S. Trustee to appoint a voluntary committee of unsecured creditors. Ordinarily, the committee is composed of those creditors who hold the seven largest unsecured claims, although other factors such as the nature of the claim and whether it is subordinated by special agreement to other types of claims will also be taken into consideration. Service on the creditors' committee is strongly encouraged, but purely voluntary.

A. What Are The Committee's First Steps?

At the first creditors' committee meeting, you will:

1. Elect a chairperson who will function as the primary liaison with the debtor and the committee's professionals;
2. Discuss the status of the case, with and without the debtor present;
3. Select committee counsel, if you wish to do so at this point;
4. Consider whether and which of the committee's powers should be invoked; and
5. Make arrangements for future meetings

B. May The Committee Hire Professionals?

The creditors' committee may hire attorneys, financial advisors, accountants, appraisers, and other professionals that it believes would assist the committee in carrying out its functions. The committee, however, must first obtain approval of the Bankruptcy Court to employ the professionals, so that they may have their fees paid from estate assets. You should note that the approved professionals will have their administrative claims paid in full from the estate before unsecured claims are paid at all. Therefore, it is in the interest of the creditors for the committee to monitor and hold down professional fees as much as possible.

1. HOW CAN THE COMMITTEE MONITOR PROFESSIONAL FEES?

When interviewing professionals such as lawyers and accountants, the committee should ask questions regarding costs and how the candidates intend to control them. Obviously, you should ask how much they will charge hourly, but you should also ask what they estimate the

total job will cost. Ask them to submit budgets and be sure the professionals provide you with monthly statements of their charges so you can review them on an ongoing basis.

The importance of monitoring monthly statements cannot be overstated. Before any claims by lawyers, accountants, real estate brokers or any committee professionals can be paid, the professionals must submit applications for approval of their fees. The Office of the U.S. Trustee reviews these applications. However, since the U.S. Trustee is not the recipient of the services, we have no way of knowing whether the professionals did what you wanted them to or whether their performance was adequate. For that reason, the U.S. Trustee Guidelines require that the chairperson of the creditors' committee certify in writing that the committee has reviewed and approved the bills before they are submitted to the Court for allowance and payment.

Keep in mind that every dollar paid to the professionals is a dollar that might otherwise go to you. Creditors' committees should take an active role in reviewing and commenting on the applications of all professionals - including those retained by the debtor. But committees should particularly scrutinize their own professionals. You are the client; only you can effectively review the fees of your own professionals.

2. HOW CAN THE COMMITTEE CONTAIN PROFESSIONAL FEES?

It is important to establish guidelines for all committee professionals. With attorneys, for example, you should discuss overall strategy and you may wish to insist upon full prior consultation on whether to file extensive court papers, undertake time consuming research projects, or conduct discovery. Other areas in which you may want to be involved are approval of the professionals' initial staffing and any staffing increases.

You should consult with your attorneys about whether they should charge for time spent educating junior lawyers in the area of law for which they are already assumed to have expertise or for researching local rules and basic procedures. If you have approved a staffing change, your attorneys or other professionals should be advised to minimize the charges to the committee for bringing the replacement professional up to speed. Also, the committee should consider placing more specific controls on the professionals. For example, the committee might limit representation to only one lawyer or accountant per meeting without prior approval.

C. What Are The Committee's Duties And Powers?

The creditors' committee has the duty to monitor the business affairs of the debtor. For example, each time one of the debtor's lawyers comes into Bankruptcy Court proposing the hiring of additional lawyers, accountants, financial advisors, real estate brokers, or each time the debtor desires court approval to continue performing contracts, continue leases, reach settlements with other creditors, or any other extraordinary measure that would affect the funds in the estate, your money and the money of other unsecured creditors is directly at stake. The creditors' committee will need to determine whether to support, oppose, or take no position on such matters. The creditors' committee will also want to monitor the debtor's daily handling of cash since the money at stake could be the members' own.

1. HOW DOES THE CREDITORS' COMMITTEE GET INFORMATION ABOUT THE DEBTOR'S FINANCES?

The Office of the U.S. Trustee requires the debtor to regularly file profit and loss statements and reports which state how much money has gone in and out of the debtor's bank accounts. These reports should provide valuable information for the creditor's committee in monitoring the debtor's conduct and finances. They should also assist the committee in plan negotiations with the debtor. You may want to request that the debtor provide you with copies of all such filings. You may also request that the debtor meet with the creditors' committee to answer your questions or provide you with operational updates.

2. WHAT ARE THE FIDUCIARY DUTIES OF CREDITORS' COMMITTEE MEMBERS?

You represent the interests of holders of claims represented by the committee. You are their fiduciary. You are required to be honest, trustworthy and without conflicting interests, with undivided loyalty and allegiance to your constituency. For example, suppose you have been appointed to serve on an unsecured creditors' committee based on the debtor owing you \$5,000,000, and further suppose that if a particular plan is confirmed the debtor will have to purchase an expensive piece of machinery of the type you happen to sell. You may not consider the potential profit you might make on such a sale in any decisions you undertake as a member of the creditors' committee, nor may you use your position on the committee to persuade the debtor to purchase the machinery from you if the plan is approved.

As a member of the creditors' committee, you will also be prevented from undertaking certain activities because of your access to information as a committee member. For example, members of the committee may engage in the purchase and sale of publicly traded securities of the debtor only if:

- a. the trading activity is a regular part of the member's business;
- b. the court approves the establishment of an information barrier that ensures trading decision makers cannot and will not receive any "insider" information from the committee representatives; and
- c. the trading activity at issue is subject to the securities laws and the oversight of the Securities and Exchange Commission.

Committee members are also restricted from selling their claims to anyone but another committee member.

3. WHAT ABOUT THE EXPENSES OF CREDITORS' COMMITTEE MEMBERS?

Creditors' committee members may have their reasonable and necessary actual expenses

for attending meetings reimbursed from the estate. Thus, reasonable travel costs and hotel and meal expenses can be charged, although such expenditures must be approved by the Bankruptcy Court before they can be reimbursed. Normally, local creditors are not expected to incur reimbursable expenses, and there is no payment for the time or lost income, etc., of committee members.

4. WHAT POWERS ARE AVAILABLE TO THE CREDITORS' COMMITTEE TO KEEP THE BANKRUPTCY PROCEEDING ON TRACK?

As the case continues, the committee may begin to question its progress, the integrity or competence of the debtor's management, or the likelihood of a successful plan of reorganization. The creditors' committee is empowered to investigate the financial condition of the debtor and the desirability of the continuance of the debtor's business. If the creditors' committee determines that it is in the best interest of the estate and creditors to have the debtor cease business or to have control of the business taken away from the debtor and be given to an impartial third party, the committee may:

- a.** Ask the Bankruptcy Court to appoint an examiner, generally an accountant or attorney, to investigate the business and file a report regarding the viability of the business, the competence of past or current management, possible fraud, etc.;
- b.** Request the appointment of a trustee - an independent third party charged with the responsibility of controlling the estate's assets; or
- c.** Ask the Bankruptcy Court to either dismiss the case or to convert it to one under chapter 7 (liquidation). One cause for dismissal or conversion is unreasonable delay that is prejudicial to creditors.

III. CONCLUSION

Participation on a creditors' committee is a serious responsibility. It requires the committee member to undertake fiduciary obligations and to incur expenses. At the same time, it is a very important part of the bankruptcy process. The participation of a creditors' committee is the most effective check on the conduct of the debtor. By playing an active role, the creditors assure that their interests will be protected and that the business will have the best possible chance of reorganizing.